n46 Interagency Credit Risk Guidance for Home Equity Lending, SR 05-11 (May 16, 2005), available at *http://www.federalreserve.gov/boarddocs/srletters/2005/sr0511a1.pdf.*; Addendum to Credit Risk Guidance for Home Equity Lending, SR 06-15 (Sept. 29, 2006), available at *http://www.federalreserve.gov/BoardDocs/SRLetters/2006/SR0615a3.pdf.*

Several national trade associations and a few large lenders voiced strong support for excluding HELOCs, generally for the reasons the Board cited. Several consumer and civil rights groups disagreed, contending that enough HELOCs are securitized to raise doubts that the originator's interests are sufficiently aligned with the borrower's interests. They maintained that Regulation Z disclosures and limitations for HELOCs are not adequate to protect consumers, and pointed to specific cases in which unaffordable HELOCs had been extended. Other commenters, such as an association of state regulators, agreed that HELOCs should be covered. Commenters offered very few concrete suggestions, however, for how to determine which HELOCs would be covered, such as an index and threshold.

The Board is adopting the proposal for the reasons stated. The Board recognizes, however, that HELOCs present a risk of circumvention. Creditors may seek to evade limitations on closed-end transactions by structuring such transactions as open-end transactions. In § 226.35(b)(5), discussed below in part IX.E, the Board prohibits structuring a closed-end loan as an open-end transaction for the purpose of evading the new rules in § 226.35.

Other Exemptions Adopted

The other proposed exclusions drew limited comment. A couple of commenters expressed support for excluding reverse mortgages while a couple of commenters opposed it. A few large lenders voiced support for excluding construction-only loans. A few commenters voiced support for the exclusion of temporary bridge loans of 12 months or less, and none of the commenters seemed to oppose it. The Board is adopting the proposed exclusions for reverse mortgages, construction-only loans, and temporary or bridge loans of 12 months or less. [*44539]

Reverse mortgages. The Board is keenly aware of consumer protection concerns raised by the expanding market for reverse mortgages, which are complex and are sometimes marketed with other complex financial products. Unique aspects of reverse mortgages--for example, the borrower's repayment ability is based on the value of the collateral rather than on income--suggest that they should be addressed separately from this final rule. The Board is reviewing this segment of the mortgage market in connection with its comprehensive review of Regulation Z to determine what measures may be required to ensure consumers are protected.

Construction-only loans. Section 226.35 excludes a construction-only loan, defined as a loan solely for the purpose of financing the initial construction of a dwelling, consistent with the definition of a "residential mortgage transaction" in § 226.2(a)(24). A construction-only loan does not include the permanent financing that replaces a construction loan. Construction-only loans do not appear to present the same risk of consumer abuse as other loans the proposal would cover. The permanent financing, or a new home-secured loan following construction, would be covered by proposed § 226.35 depending on its APR. Applying § 226.35 to construction-only loans, which generally have higher interest rates than the permanent financing, could hinder some borrowers' access to construction financing without meaningfully enhancing consumer protection

Bridge loans. HOEPA now covers certain bridge loans with rates or fees high enough to make them HOEPA loans. TILA Section 129(l)(1) provides the Board authority to exempt classes of mortgage transactions from HOEPA if the Board finds that the exemption is in the interest of the borrowing public and will apply only to products that maintain and strengthen homeownership and equity protection. 15 U.S.C. 1639(l)(2). The Board believes a narrow exemption for bridge loans from the restrictions of § 226.35, as they apply to HOEPA loans, would be in borrowers' interest and support homeownership.

The final rule, like the proposed rule, gives as an example of a "temporary or bridge loan" a loan to purchase a new dwelling where the consumer plans to sell a current dwelling within 12 months. This is not the only potential *bona fide* example of a temporary or bridge loan. The Board does expect, however, that the temporary or bridge loan exemption will be applied narrowly and not to evade or circumvent the regulation. For example, a 12-month loan with a substantial balloon payment would not qualify for the exemption where it was clearly intended to lead a borrower to refinance repeatedly into a chain of 12-month loans.

Exemptions Not Adopted

Industry commenters proposed additional exclusions that the Board is not adopting.

Government-guaranteed loans. Some commenters proposed excluding loans with federal guaranties such as FHA, VA, and Rural Housing Service. They suggested that the federal regulations that govern these loans are sufficient to protect consumers, and that new regulations under HOEPA were not only unnecessary but could cause confusion. At least one commenter also suggested excluding loans with state or local agency guaranties.

The Board does not believe that exempting government-guaranteed loans from § 226.35 is appropriate. It is not clear what criteria the Board would use to decide precisely which government programs would be exempted; commenters did not offer concrete suggestions. Moreover, such exemptions could attract to agency programs less scrupulous originators seeking to avoid HOEPA's civil liability, with serious unintended consequences for consumers as well as for the agencies and taxpayers.

Jumbo loans. A few commenters proposed excluding non-conforming or "jumbo" loans, that is, loans that exceed the threshold amount for eligibility for purchase by Fannie Mae or Freddie Mac. They cited a lack of evidence of widespread problems with jumbo loan performance, and a belief that borrowers who can afford jumbo loans are more sophisticated consumers and therefore better able to protect themselves.

The Board does not believe excluding jumbo loans would be appropriate. The request is based on certain assumptions about the characteristics of the borrowers who take out jumbo loans. In fact, jumbo loans are offered in the subprime and alt-A markets and not just in the prime market. A categorical exemption of jumbo loans could therefore seriously undermine protections for consumers, especially in areas with above-average home prices.

Portfolio loans. A commenter proposed excluding loans held in portfolio on the basis that a lender will take more care with these loans. Among other concerns with such an exemption is that it often cannot be determined as of consummation whether a loan will be held in portfolio or sold immediately--or, if held, for how long before being sold. Therefore, such an exception to the rule does not appear practicable and could present significant opportunities for evasion.

IX. Final Rules for Higher-Priced Mortgage Loans and HOEPA Loans

A. Overview

This part discusses the new consumer protections the Board is applying to "higher-priced mortgage loans" and HOEPA loans. Creditors are prohibited from extending credit without regard to borrowers' ability to repay from sources other than the collateral itself. The final rule differs from the proposed rule in that it removes the proposed "pattern or practice" phrase and adds a presumption of compliance when certain underwriting procedures are followed. Creditors are also required to verify income and assets they rely upon to determine repayment ability, and to establish escrow accounts for property taxes and insurance. In addition, a higher-priced mortgage loan may not have a prepayment penalty except under certain conditions. These conditions are substantially narrower than those proposed.

The Board finds that the prohibitions in the final rule are necessary to prevent practices that the Board finds to be unfair, deceptive, associated with abusive lending practices, or otherwise not in the interest of the borrower. *See* TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), and the discussion of this statute in part V above.

The Board is also adopting the proposed rule prohibiting a creditor from structuring a closed-end mortgage loan as an open-end line of credit for the purpose of evading the restrictions on higher-priced mortgage loans, which do not apply to open-end lines of credit. This rule is based on the authority of the Board under TILA Section 129(l)(2) to prohibit practices that would evade Board regulations adopted under authority of that statute. 15 U.S.C. 1639(l)(2).

B. Disregard of Consumer's Ability To Repay--§§ 226.34(a)(4) and 226.35(b)(1)

TILA Section 129(h), 15 U.S.C. 1639(h), and Regulation Z § 226.34(a)(4) prohibit a pattern or practice of extending credit subject to § 226.32 (HOEPA loans) based on consumers' collateral without regard to their repayment ability. The regulation creates a presumption of a violation where a creditor has a pattern or practice of failing to verify and document repayment ability. The Board [*44540] proposed to revise the prohibition on disregarding repayment ability and extend it, through proposed § 226.35(b)(1), to higher-priced mortgage loans as defined in § 226.35(a). The proposed revisions included adding several rebuttable presumptions of violations for a pattern or practice of failing to follow certain underwriting procedures, and a safe harbor.

The final rule removes "pattern or practice" and therefore prohibits any HOEPA loan or higher-priced mortgage loan from being extended based on the collateral without regard to repayment ability. Verifying repayment ability has

been made a requirement rather than a presumptive requirement. The proposal provided that a failure to follow any one of several specified underwriting procedures would create a presumption of a violation. In the final rule, those procedures, with modifications, have instead been incorporated into a presumption of compliance which replaces the proposed safe harbor.

Public Comment

Mortgage lenders and their trade associations that commented generally, but not uniformly, support or at least do not oppose a rule requiring creditors to consider repayment ability. They maintain, however, that the rule as drafted would unduly constrain credit availability because of the combination of potentially significant damages under TILA Section 130, 15 U.S.C. 1640, and a perceived lack of a clear and flexible safe harbor. These commenters stated that two elements of the rule that the Board had intended to help preserve credit availability--the "pattern or practice" element and a safe harbor for a creditor having a reasonable expectation of repayment ability for at least seven years--would not have the intended effect. Many of these commenters suggested that the rule would unduly constrain credit unless the Board removed the presumptions of violations and provided a clearer and more specific safe harbor. Some of these commenters also requested additional safe harbors, such as for use of an automated underwriting system (AUS) of Fannie Mae or Freddie Mac.

Consumer, civil rights, and community development groups, as well as some state and local government officials, several members of Congress, a federal regulator, and others argued that "pattern or practice" seriously weakened the rule and urged its removal. They maintain that "pattern or practice" would effectively prevent an individual borrower from bringing a claim or counter-claim based on his or her loan, and reduce the rule's deterrence of irresponsible lending. These commenters generally support the proposed presumptions of violations but many of them urged the Board to adopt quantitative standards for the proposed presumptions for failing to consider debt-to-income ratios (DTI) and residual income levels. As discussed above, these commenters also would apply the rule to nontraditional mortgages regardless of price, and a few would apply the rule to the entire mortgage market including the prime market.

The comments are discussed in more detail throughout this section as applicable.

Discussion

The Board finds that disregarding a consumer's repayment ability when extending a higher-priced mortgage loan or HOEPA loan, or failing to verify the consumer's income, assets, and obligations used to determine repayment ability, are unfair practices. This section discusses the evidence from recent events of a disregard for repayment ability and reliance on unverified incomes in the subprime market; the substantial injuries that disregarding repayment ability and failing to verify income causes consumers; the reasons consumers cannot reasonably avoid these injuries; and the Board's basis for concluding that the injuries are not outweighed by countervailing benefits to consumers or competition when repayment ability is disregarded or income is not verified.

Evidence of a recent widespread disregard of repayment ability. Approximately three-quarters of securitized originations in subprime pools from 2003 to 2007 were 2-28 or 3-27 ARMs with a built-in potential for significant payment shock at the start of the third or fourth year, respectively. n47 Originations of these types of mortgages during 2005 and 2006 and through early 2007 have contributed significantly to a substantial increase in serious delinquencies and foreclosures. The proportion of all subprime mortgages past-due ninety days or more ("serious delinquency") was about 13 percent in October 2007, more than double the mid-2005 level. n48 Adjustable-rate subprime mortgages reached a serious delinquency rate of almost 28 percent in May 2008, quintuple the mid-2005 level. The serious delinquency rate has also risen for loans in alt-A (near prime) securitized pools to almost 8 percent (as of April 2008) from less than 2 percent only a year ago. In contrast, 1.5 percent of loans in the prime-mortgage sector were seriously delinquent as of April 2008.

n47 In a typical case of a 2-28 discounted ARM, a $ 200,000 loan with a discounted rate of 7 percent for two years (compared to a fully-indexed rate of 11.5 percent) and a 10 percent maximum rate in the third year would start at a payment of $ 1,531 and jump to a payment of $ 1,939 in the third year, even if the index value did not increase. The rate would reach the fully-indexed rate in the fourth year (if the index value still did not change), and the payment would increase to $ 2,152. The example assumes an initial index of 5.5 percent and a margin of 6 percent; assumes annual payment adjustments after the initial discount period; a 3 percent cap on the interest rate increase at the end of year 2; and a 2 percent annual payment adjustment cap on interest rate increases thereafter, with a lifetime payment adjustment cap of 6 percent (or a maximum rate of 13 percent).

n48 Delinquency rates calculated from data from First American LoanPerformance on mortgages in subprime securitized pools. Figures include loans on non-owner-occupied properties.

Higher delinquencies have shown through to foreclosures. Foreclosures were initiated on some 1.5 million U.S. homes during 2007, up 53 percent from 2006, and the rate of foreclosure starts looks to be higher yet for 2008. Lenders initiated over 550,000 foreclosures in the first quarter of 2008, about 274,000 of them on subprime mortgages. This was significantly higher than the quarterly average of 440,000 foreclosures in the second half of 2007 and 325,000 in the first half, and twice the quarterly average of 225,000 for the past six years. n49

n49 Estimates are based on data from *MBA Nat'l Delinquency Survey.*

Payment increases on 2-28 and 3-27 ARMs have not been a major cause of the increase in delinquencies and foreclosures because most delinquencies occurred before the payments were adjusted. Rather, a major contributor to these delinquencies was lenders' extension of credit on the basis of income stated on applications without verification. n50 Originators had strong incentives to make these "stated income" loans, and consumers had incentives to accept them. Because the loans could be originated more quickly, originators, who were paid based on volume, could increase their earnings by originating more of them. The share of "low doc" and "no doc" loan originations in the securitized subprime market rose from 20 percent in 2000, to 30 percent in 2004, to 40 percent in 2006. n51 The prevalence of stated income lending left wide room for the loan officer, mortgage broker, or consumer to overstate the consumer's income so the consumer could qualify for a larger loan [*44541] and the loan officer or broker could receive a larger commission. There is substantial anecdotal evidence that borrower incomes were commonly inflated. n52

n50 *See* U.S. Gov't Accountability Office, GAO-08-78R, *Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments* 5 (2007); Fannie Mae, *Weekly Economic Commentary* (Mar. 26, 2007).

n51 Figures calculated from First American LoanPerformance data.

n52 *See* Mortgage Asset Research Inst., Inc., *Eighth Periodic Mortgage Fraud Case Report to the Mortgage Bankers Association* (2006) (reporting that 90 of 100 stated income loans sampled used inflated income when compared to tax return data); Fitch Ratings, *Drivers of 2006 Subprime Vintage Performance* (November 13, 2007) *(Fitch 2006 Subprime Performance)* (reporting that stated income loans with high combined loan to value ratios appear to have become vehicles for fraud).

Lenders relying on overstated incomes to make loans could not accurately assess consumers' repayment ability. n53 Evidence of this failure is found in the somewhat steeper increase in the rate of default for low/no doc loans originated when underwriting standards were declining in 2005 and 2006 relative to full documentation loans. n54 Due in large part to creditors' reliance on inaccurate "stated incomes," lenders often failed to determine reliably that the consumer would be able to afford even the initial discounted payments. Almost 13 percent of the 2-28 ARMs originated in 2005 appear to have become seriously delinquent before their first reset. n55 While some of these borrowers may have been able to make their payments--but stopped because their home values declined and they lost what little equity they had--others were not able to afford even their initial payments.

n53 Consumers may also have been led to pay more for their loans than they otherwise would. There is generally a premium for a stated income loan. An originator may not have sufficient incentive to disclose the premium on its own initiative because collecting and reviewing documents could slow down the origination process, reduce the number of loans an originator produces in a period, and, therefore, reduce the originator's compensation for the period. Consumers who are unaware of this premium are effectively deprived of an opportunity to shop for a potentially lower-rate loan requiring full documentation.

n54 Determined from First American LoanPerformance data. *See also Fitch 2006 Subprime Performance* (stating that lack of income verification, as opposed to lack of employment or down payment verification, caused 2006 low documentation loans delinquencies to be higher than earlier vintages' low documentation loans).

n55 Figure calculated from First American LoanPerformance data.

Although payment shock on 2-28 and 3-27 ARMs did not contribute significantly to the substantial increase in delinquencies, there is reason to believe that creditors did not underwrite to a rate and payment that would take into account the risk to consumers of a payment shock. Creditors also may not have factored in the consumer's obligation for

the expected property taxes and insurance, or the increasingly common "piggyback" second-lien loan or line of credit a consumer would use to finance part or all of the down payment.

By frequently basing lending decisions on overstated incomes and understated obligations, creditors were in effect often extending credit based on the value of the collateral, that is, the consumer's house. Moreover, by coupling these practices with a practice of extending credit to borrowers with very limited equity, creditors were often extending credit based on an expectation that the house's value would appreciate rapidly. n56 Creditors may have felt that rapid house price appreciation justified loosening their lending standards, but in some locations house price appreciation was fed by loosened standards, which permitted consumers to take out larger loans and bid up house prices. Loosened lending standards therefore made it more likely that the inevitable readjustment of house prices in these locations would be severe.

n56 Often the lender extended credit knowing that the borrower would have no equity after taking into account a simultaneous second-lien ("piggyback") loan. According to *Fitch 2006 Subprime Performance,* first-lien loans in subprime securitized pools with simultaneous second liens rose from 1.1 percent in 2000 to 6.4 percent in 2003 to 30 percent in 2006. Moreover, in some cases the appraisal the lender relied on overstated borrower equity because the lender or broker pressured the appraiser to inflate the house value. The prohibition against coercing appraisers is discussed below in part X.B.

House price appreciation began to slow in 2006 and house price levels actually began to decline in many places in 2007. Borrowers who could not afford their mortgage obligations because their repayment ability had not been assessed properly found it more difficult to lower their payments by refinancing. They lacked sufficient equity to meet newly tightened lending standards, or they had negative equity, that is, they owed more than their house was worth. For the same reasons, many consumers also could not extinguish their mortgage obligations by selling their homes. Declining house prices led to sharp increases in serious delinquency rates in both the subprime and alt-A market segments, as discussed above. n57

n57 Estimates are based on data from *MBA Nat'l Delinquency Survey.*

Although the focus of § 226.35 is the subprime market, it may cover part of the alt-A market. Disregard for repayment ability was often found in the alt-A market as well. Alt-A loans are made to borrowers who typically have higher credit scores than subprime borrowers, but the loans pose more risk than prime loans because they involve small down payments or reduced income documentation, or the terms of the loan are nontraditional. According to one estimate, loans with nontraditional terms that permitted borrowers to defer principal ("interest-only") or both principal and some interest ("option ARM") in exchange for higher payments later--reached 78 percent of alt-A originations in 2006. n58 The combination of a variable rate with a deferral of principal and interest held the potential for substantial payment shock within five years. Yet rising delinquency rates to almost 8 percent in 2008, from less than 1 percent in 2006, could suggest that lenders too often assessed repayment ability at a low interest rate and payment that did not adequately account for near-certain payment increases. In addition, these loans typically were made based on reduced income documentation. For example, the share of interest-only mortgages with low or no documentation in alt-A securitized pools increased from around 64 percent in 2003 to nearly 80 percent in 2006. n59 It is generally accepted that the reduced documentation of income led to a high degree of income inflation in the alt-A market just as it did in the subprime market.

n58 David Liu and Shumin Li, *Alt-A Credit--The Other Shoe Drops?,* The MarketPulse (First American LoanPerformance, Inc., San Francisco, Cal.) Dec. 2006.

n59 Figures calculated from First American LoanPerformance data.

Substantial injury. A borrower who cannot afford to make the loan payments as well as payments for property taxes and homeowners insurance because the lender did not adequately assess the borrower's repayment ability suffers substantial injury. Missing mortgage payments is costly: Large late fees are charged and the borrower's credit record is impaired, reducing her credit options. If refinancing to a loan with a lower payment is an option (for example, if the borrower can obtain a loan with a longer maturity), refinancing can slow the rate at which the consumer is able to pay down principal and build equity. The borrower may have to tap home equity to cover the refinancing's closing costs or may have to accept a higher interest rate in exchange for the lender paying the closing costs. If refinancing is not an option, then the borrower and household must make sacrifices to keep the home such as reducing other expenditures or taking additional jobs. If keeping the home is not tenable, the borrower must sell it or endure foreclosure, the costs of which (for example, property maintenance costs, attorneys fees, and other fees passed on to the consumer) will erode any eq-

uity [*44542] the consumer had. The foreclosure will mar the consumer's credit record and make it very difficult for the consumer to become a homeowner again any time soon. Many borrowers end up owing the lender more than the house is worth, especially if their homes are sold into a declining market as is happening today in many parts of the country. Foreclosures also may force consumers to move, which is costly and disruptive. In addition to the financial costs of unsustainable lending practices, borrowers and households can suffer serious emotional hardship.

If foreclosures due to irresponsible lending rise rapidly or reach high levels in a particular geographic area, then the injuries can extend beyond the individual borrower and household to the larger community. A foreclosure cluster in a neighborhood can reduce homeowner equity throughout the neighborhood by bringing down prices, eroding the asset that for many households is their largest. n60 A significant rise in foreclosures can create a cycle where foreclosures bring down property values, reducing the ability and incentive of homeowners, particularly those under stress for other reasons, to retain their homes. Foreclosure clusters also can lower municipal tax revenues, reducing a locality's ability to maintain services and make capital investments. At the same time, revenues may be diverted to mitigating hazards that clusters of vacant homes can create. n61

n60 *E.g.,* Zhenguo Lin, et al. *Spillover Effects of Foreclosures on Neighborhood Property Values,* Journal of Real Estate Finance and Economics Online (Nov. 2007), available at *http://www.springerlink.com/content/rk4q0p4475vr3473/fulltext.pdf.*

n61 *E.g.,* William C. Apgar and Mark Duda. *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom* (Minneapolis: Homeownership Preservation Foundation 2005).

Lending without regard to repayment ability also has other consequences. It facilitates an abusive strategy of "flipping" borrowers in a succession of refinancings designed ostensibly to lower borrowers' burdensome payments that actually convert borrowers' equity into fees for originators without providing borrowers a benefit. Moreover, relaxed standards, such as those that pervaded the subprime market recently, may increase the incidence of abusive lending practices by attracting less scrupulous originators into the market while at the same time bringing more vulnerable borrowers into the market. The rapid influx of new originators that can accompany a relaxation of lending standards makes it more difficult for regulators and investors alike to distinguish responsible from irresponsible actors. *See* supra part II.

Injury not reasonably avoidable. One might assume that borrowers could avoid unsustainable loans by comparing their current and expected incomes to their current and expected expenses, including the scheduled loan payments disclosed under TILA and an estimate of property taxes and homeowners insurance. There are several reasons, however, why consumers, especially in the subprime market, accept risky loans they will struggle or fail to repay. In some cases, originators mislead borrowers into entering into unaffordable loans by understating the payment before closing and disclosing the true payment only at closing ("bait and switch"). At the closing table, many borrowers may not notice the disclosure of the payment amount or have time to consider it because borrowers are typically provided with many documents to sign then. Borrowers who consider the disclosure may nonetheless feel constrained to close the loan, for a number of reasons. They may already have paid substantial fees and expect that more applications would require more fees. They may have signed agreements to purchase a new house and sell the current house. Or they may need to escape an overly burdensome payment on a current loan, or urgently need the cash that the loan will provide for a household emergency.

Furthermore, many consumers in the subprime market will accept loans knowing they may have difficulty affording the payments because they reasonably believe a more affordable loan will not be available to them. As explained in part II.B, limited transparency of prices, products, and originator incentives reduces a borrower's expected benefit from shopping further for a better option. Moreover, taking more time to shop can be costly, especially for the borrower in a financial pinch. Thus, borrowers often make a reasoned decision to accept unfavorable terms.

Furthermore, borrowers' own assessment of their repayment ability may be influenced by their belief that a lender would not provide credit to a consumer who did not have the capacity to repay. Borrowers could reasonably infer from a lender's approval of their applications that the lender had appropriately determined that they would be able to repay their loans. Borrowers operating under this impression may not independently assess their repayment ability to the extent necessary to protect themselves from taking on obligations they cannot repay. Borrowers are likely unaware of market imperfections that may reduce lenders' incentives to fully assess repayment ability. See part II.B. And borrowers would not realize that a lender was applying loose underwriting standards such as assessing repayment ability on the basis of a "teaser" payment. In addition, originators may sometimes encourage borrowers to be excessively optimistic about their ability to refinance should they be unable to sustain repayment. For example, they sometimes offer reassurances that

interest rates will remain low and house prices will increase; borrowers may be swayed by such reassurances because they believe the sources are experts.

Stated income and stated asset loans can make it even more difficult for a consumer to avoid an unsustainable loan. With stated income (or stated asset) loans, the applicant may not realize that the originator is inflating the applicant's income and assets to qualify the applicant for the loan. Applicants do not necessarily even know that they are being considered for stated income or stated asset loans. They may give the originator documents verifying their income and assets that the originator keeps out of the loan file because the documents do not demonstrate the income and assets needed to make the loan. Moreover, if a consumer knowingly applies for a stated income or stated asset loan and correctly states her income or assets, the originator can write an inflated figure into the application form. It is typical for the originator to fill out the application for the consumer, and the consumer may not see the written application until closing, when the borrower often is provided with numerous documents to review and sign and may not review the application form with care. The consumer who detects the inflated numbers at the closing table may not realize their importance or may face constraints that make it particularly difficult to walk away from the table without the loan.

Some consumers may also overstate their income or assets with the encouragement of a loan originator who makes it clear that the consumer's actual income or assets are not high enough to qualify them for the loans they seek. Such originators may reassure applicants that this is a benign and common practice. In addition, applicants may inflate their incomes and assets on their own initiative in circumstances where the originator does not have reason to know.

For all of these reasons, borrowers cannot reasonably avoid injuries from lenders' disregard of repayment ability. [*44543] Moreover, other consumers who are not parties to irresponsible transactions but suffer from their spillover effects have no ability to prevent these injuries.

Injury not outweighed by countervailing benefits to consumers or to competition. There is no benefit to consumers or competition from loans that are extended without regard to consumers' ability to make even the initial payments. There may be some benefit to consumers from loans that are underwritten based on the collateral and without regard to consumers' ability to sustain their payments past some initial period. For example, a consumer who has lost her principal source of income may benefit from being able to risk her home and her equity in the hope that, before she exhausts her savings, she will obtain a new job that will generate sufficient income to support the payment obligation. The Board believes, however, that this rare benefit is outweighed by the substantial costs to most borrowers and communities of extending higher-risk loans without regard to repayment ability. (Adopting exceptions to the rule for hardship cases would create significant potential loopholes and make the rule unduly complex. The final rule does, however, contain an exemption for temporary or "bridge" loans of 12 months or less, though this exemption is intended to be construed narrowly.)

The Board recognizes as well that stated income (or stated asset) lending has at least three potential benefits for consumers and competition. It may speed credit access for consumers who need credit on an emergency basis, save some consumers from expending significant effort to document their income, and provide access to credit for consumers who cannot document their incomes. The first two benefits are limited relative to the substantial injuries caused by lenders' relying on unverified incomes. The third benefit is also limited given that consumers who file proper tax returns can use at least these documents, if no others are available, to verify their incomes. Among higher-priced mortgage loans, where risks to consumers are already elevated, the potential benefits to consumers of stated income/stated asset lending are outweighed by the potential injuries to consumers and competition.

Final Rule

HOEPA and § 226.34(a)(4) currently prohibit a lender from engaging in a pattern or practice of extending HOEPA loans based on the consumer's collateral without regard to the consumer's repayment ability, including the consumer's current and expected income, current obligations, and employment. Section 226.34(a)(4) currently provides that a creditor is presumed to have violated this prohibition if it engages in a pattern or practice of failing to verify repayment ability.

The Board proposed to extend this prohibition to higher-priced mortgage loans, *See* proposed § 226.35(b)(1), and to add several additional rebuttable presumptions of violation as well as a safe harbor. Under the proposal a creditor would have been presumed to violate the regulation if it engaged in a pattern or practice of failing to consider: consumers' ability to pay the loan based on the interest rate specified in the regulation (§ 226.34(a)(4)(i)(B)); consumers' ability to make fully-amortizing loan payments that include expected property taxes and homeowners insurance (§ 226.34(a)(4)(i)(C)); the ratio of borrowers' total debt obligations to income as of consummation (§ 226.34(a)(4)(i)(D));

and borrowers' residual income (§ 226.34(a)(4)(i)(E)). The proposed safe harbor appeared in § 226.34(a)(4)(ii), which provided that a creditor does not violate § 226.34(a)(4) if the creditor has a reasonable basis to believe that consumers will be able to make loan payments for at least seven years, considering each of the factors identified in § 226.34(a)(4)(i) and any other factors relevant to determining repayment ability.

The final rule removes the "pattern or practice" qualification and therefore prohibits a creditor from extending any HOEPA loan or higher-priced mortgage loan based on the collateral without regard to repayment ability. Like the proposal, the final rule provides that repayment ability is determined according to current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations such as expected property tax and insurance obligations. *See* § 226.34(a)(4) and (a)(4)(i); § 226.35(b)(1). The final rule also shifts the proposed new presumptions of violations to a presumption of compliance, with modifications. The presumption of compliance is revised to specify a finite set of underwriting procedures; the reference to "any other factors relevant to determining repayment ability" has been removed. *See* § 226.34(a)(4)(iii). The presumption of violation for failing to verify repayment ability currently in § 226.34(a)(4)(i), however, is being finalized instead as an explicit requirement to verify repayment ability. *See* § 226.34(a)(4)(ii). This section discusses the basic prohibition, and ensuing sections discuss the removal of pattern or practice, the verification requirement, and the presumption of compliance.

As discussed above, the Board finds extending higher-priced mortgage loans or HOEPA loans based on the collateral without regard to the consumer's repayment ability to be an unfair practice. The final rule prohibits this practice. The Board also took into account state laws that declare extending loans to consumers who cannot repay an unfair practice. n62

n62 *See, e.g.*, Ind. Code §§ 24-4.5-6-102, 24-4.5-6-111(l)(3); Mass. Gen. Laws ch. 93A, ch. 183 §§ 4, 18(a); W.V. Code § 46A-7-109(3)(a).

Section 226.34(a)(4) governs the process for extending credit; it is not intended to dictate which types of credit or credit terms are permissible and which are not. The rule does not prohibit potentially riskier types of loans such as loans with balloon payments, loans with interest-only payments, or ARMs with discounted initial rates. With proper underwriting, such products may be appropriate for certain borrowers in the subprime market. The regulation merely prohibits a creditor from extending such products or any other higher-priced mortgage loans without adequately evaluating repayment ability.

The rule is intended to ensure that creditors do not assess repayment ability using overstated incomes or understated payment obligations. The rule explicitly requires that the creditor verify income and assets using reliable third party documents and, therefore, prohibits relying merely on an income statement from the applicant. *See* § 226.34(a)(4)(ii). (This requirement is discussed in more detail below.) In addition, the rule requires assessing not just the consumer's ability to pay loan principal and interest, but also the consumer's ability to pay property taxes, homeowners insurance, and similar mortgage-related expenses. Mortgage-related expenses, such as homeowner's association dues or condominium or cooperative fees, are included because failure to pay them could result in a consumer's default on his or her mortgage (if, for example, failure to pay resulted in a senior lien on the unit that constituted a default under the terms of the consumer's mortgage obligations). *See* §§ 226.34(a)(4); 226.34(a)(4)(i).

As of consummation. The final rule provides, as did the proposed rule, that the creditor is responsible for assessing repayment ability as of consummation. Two industry trade associations expressed concern over proposed [*44544] comment 34(a)(4)-2, indicating that, while a creditor would be liable only for what it knew or should have known as of consummation, events after consummation may be relevant to determining compliance. These commenters contend that creditors should not be held responsible for accurately predicting future events such as a borrower's employment stability or house price appreciation. One asserted that the rule would lead creditors to impose more stringent underwriting criteria in geographic areas with economies projected to decline. These commenters requested that the Board clarify in the commentary that post-closing events cannot be used to second-guess a lender's underwriting decision, and one requested that the commentary specifically state that a foreclosure does not create a presumption of a violation.

The Board has revised the comment, renumbered as 34(a)(4)-5, to delete the statement that events after consummation may be relevant to determining whether a creditor has violated § 226.34(a)(4), but events after consummation do not, by themselves, establish a violation. Post-consummation events such as a sharp increase in defaults could be relevant to showing a "pattern or practice" of disregarding repayment ability, but the final rule does not require proof of a pattern or practice. The final comment retains the proposed statement that a violation is not established if borrowers default because of significant expenses or income losses that occur after consummation. The Board believes it is clear from the regulation and comment that a default does not create a presumption of a violation.

Income, assets, and employment. The final rule, like the proposal, provides that sources of repayment ability include current and reasonably expected income, employment, and assets other than the collateral. For the sake of clarity, new comment 34(a)(4)-2 indicates that a creditor may base its determination of repayment ability on current or reasonably expected income, on assets other than the collateral, or both. A creditor that purported to determine repayment ability on the basis of information other than income or assets would have to clearly demonstrate that this information is probative of repayment ability.

The Board is not adopting the suggestion from several commenters to permit creditors to consider, when determining repayment ability, other characteristics of the borrower or the transaction such as credit score and loan-to-value ratio. These other characteristics may be critical to responsible mortgage underwriting, but they are not as probative as income and assets of the consumer's ability to make the scheduled payments on a mortgage obligation. For example, if a consumer has income of $ 3,000 per month, it is very unlikely that the consumer will be able to afford a monthly mortgage payment of $ 2,500 per month regardless of the consumer's credit score or loan-to-value ratio. Moreover, incorporating these other characteristics in the regulation would potentially create a major loophole for originators to discount the importance of income and assets to repayment ability. For the same reasons, the Board also is not adopting the suggestion of some commenters to permit a creditor to rely on any factor that the creditor finds relevant to determine credit or delinquency risk.

The final rule, like the proposal, provides broad flexibility as to the types of income, assets, and employment a creditor may rely on. Specific references to seasonal and irregular employment were added to comment 34(a)(4)-6 (numbered 34(a)(4)-3 in the proposal) in response to requests from commenters. References to several different types of income, such as interest and dividends, were also added. These examples are merely illustrative, not exhaustive.

The final rule and commentary also follow the proposal in permitting a lender to rely on expected income and employment, not just current income and employment. Expectations for improvements in employment or income must be reasonable and verified with third party documents. The commentary gives examples of expected bonuses verified with documents demonstrating past bonuses, and expected employment verified with a commitment letter from the future employer stating a specified salary. *See* comment 34(a)(4)(ii)-3. In some cases a loan may have a likely payment increase that would not be affordable at the borrower's income as of consummation. A creditor may be able to verify a reasonable expectation of an increase in the borrower's income that will make the higher payment affordable to the borrower.

Several commenters expressed concern over language in proposed comment 34(a)(4)-3 indicating that creditors are required, not merely allowed, to consider information about expected changes in income or employment that would undermine repayment ability. The proposed comment gave as an example that a creditor must consider information indicating that an employed person will become unemployed. Some commenters contended that it is appropriate to permit lenders to consider expected income or employment, but inappropriate to require that they do so. Creditors are concerned that they would be liable for accurately assessing a borrower's employment stability, which may depend on regional economic factors.

The final comment, renumbered as 34(a)(4)-5, is revised somewhat to address this concern. The revised comment indicates that a creditor might have knowledge of a likely reduction in income or employment and provides the following example: a consumer's written application indicates that the consumer plans to retire within twelve months or transition from full-time to part-time employment. As the example indicates, the Board does not intend to place unrealistic requirements on a creditor to speculate or inquire about every possible change in a borrower's life circumstances. The sentence "a creditor may have information indicating that an employed person will become unemployed" is deleted as duplicative.

Finally, new comment 34(a)(4)-7 addresses the concern of several commenters that the proposal appeared to require them to make inquiries of borrowers or consider information about them that Regulation B, 12 CFR part 202, would prohibit, such as a question posed solely to a female applicant as to whether she is likely to continue her employment. The comment explains that § 226.34(a)(4) does not require or permit the creditor to make inquiries or verifications that would be prohibited by Regulation B.

Obligations. The final rule, like the proposed rule, requires the creditor to consider the consumer's current obligations as well as mortgage-related obligations such as expected property tax and required insurance. *See* § 226.34(a)(4)(i). The final rule does not contain the proposed rule's reference to "expected obligations." An industry trade association suggested the reference would stifle communications between a lender and a consumer because the lender would seek to avoid eliciting information about the borrower's plans for future indebtedness, such as an intention

to take out student loans to send children to college. The Board agrees that the proposal could stifle communications. This risk does not have a sufficient offsetting benefit because it is by nature speculative whether a mortgage borrower will undertake other credit obligations in the future.

A reference to simultaneous mortgage obligations (proposed comment 34(a)(4)(i)-2)) has been retained but [*44545] revised. *See* comment 34(a)(4)-3. Several commenters objected to the proposed comment. They suggested a lender has a limited ability to identify the existence of a simultaneous obligation with an unaffiliated lender if the borrower does not self-report. They asked that the requirement be restricted to simultaneous obligations with the same lender, or that it be limited to obligations the creditor knows or has reason to know about, or that it have a safe harbor for a lender that has procedures to prevent consumers from obtaining a loan from another creditor without the lender's knowledge. The comment has been revised to indicate that the regulation makes a creditor responsible for considering only those simultaneous obligations of which the creditor has knowledge.

Exemptions. The Board is adopting the proposed exemptions from the rule for bridge loans, construction-only loans, reverse mortgages, and HELOCs. These exemptions are discussed in part VIII.H. A national bank and two trade associations with national bank members requested an additional exemption for national banks that are in compliance with OCC regulation 12 CFR 34.3(b). The OCC regulation prohibits national banks from making a mortgage loan based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral without regard to the borrower's ability to repay the loan according to its terms. Unlike HOEPA, however, the OCC regulation does not authorize private actions or actions by state attorneys general when the regulation is violated. Thus, the Board is not adopting the requested exemption.

Pattern or Practice

Based on the comments and additional information gathered by the Board, the Board is adopting the rule without the phrase "pattern or practice." The rule therefore prohibits an individual HOEPA loan or higher-priced mortgage loan from being extended based on the collateral without regard to repayment ability. TILA Section 129(l)(2), 15 U.S.C. 1638(l)(2), confers on the Board authority to revise HOEPA's restrictions on HOEPA loans if the Board finds that such revisions are necessary to prevent unfair or deceptive acts or practices in connection with mortgage loans. The Board so finds for the reasons discussed below.

Public comment. Consumer advocates and others strongly urged the Board to remove the pattern or practice element. They argued that the burden to prove a pattern or practice is so onerous as to make it impracticable for an individual plaintiff to seek relief, either affirmatively or in recoupment. They suggested a typical plaintiff does not have the resources to obtain information about a lender's loans and loan policies sufficient to allege a pattern or practice. Moreover, should a plaintiff be able to allege a pattern or practice and proceed to the discovery stage, one legal aid organization commented based on direct experience that a creditor may produce a mountain of documents that overwhelms the plaintiff's resources and makes it impractical to pursue such cases. One consumer group argued that the proposed rule would not adequately deter abuse because, by the time a pattern or practice emerged, substantial harm would already have been done to consumers and investors. This commenter also argued that other TILA provisions give creditors sufficient protection against litigation risk, such as the cap on class action damages, the right to cure certain errors creditors discover on their own, and the defense for *bona fide* errors.

Several lenders and lender trade associations expressed concern that "pattern or practice" is too vague to provide the certainty creditors seek and asked for more specific guidance and examples. Other industry commenters contended that the phrase was likely to be interpreted to hold lenders that originate large numbers of loans liable for errors in assessing repayment ability in just a small fraction of their originations. For example, one large lender pointed out that an error rate of 0.5 percent in its 400,000 HMDA-reportable originations in 2006 would have amounted to 2,000 loans. Several commenters cited cases decided under other statutes holding that a mere handful of instances were a pattern or practice. To address these concerns, two commenters requested that the phrase be changed to "systematic practice" and that this new phrase be interpreted to mean willful or reckless disregard. Industry commenters generally preferred that "pattern or practice," whatever its limitations, be retained as a form of protection against unwarranted litigation.

Discussion. The Board believes that removing "pattern or practice" is necessary to ensure a remedy for consumers who are given unaffordable loans and to deter irresponsible lending, which injures not just individual borrowers but also their neighbors and communities. The Board further believes that the presumption of compliance the Board is adopting will provide more certainty to creditors than either "pattern or practice" or the proposed safe harbor. The presumption will better aid creditors with compliance planning, and it will better help them mitigate litigation risk. In short, the